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Mr Ian Carruthers
Chairman
International Public Sector Accounting
Standards Board (IPSASB)

Comment letter on Exposure Draft 64 *Leases*

Dear Mr Carruthers,

We welcome the opportunity to comment on the above mentioned Exposure Draft 64 *Leases* ('the ED'). The following comments are made in my capacity as Accounting Officer of the European Commission responsible for, amongst other tasks, the preparation of the consolidated annual accounts of the European Union, which comprise more than 50 European Agencies, Institutions and other European Bodies with an annual budget of more than EUR 140 billion[1].

We would like to thank the International Public Sector Accounting Standard Board (the 'IPSASB') for this opportunity to contribute to the due process and we are pleased to provide you with our comments with the aim of improving the transparency, relevance and comparability of the financial statements across jurisdictions.

We generally support the IPSASB's approach to the convergence of public sector accounting standards with International Financial Reporting Standards ('the IFRS') applied in the private sector, whenever the nature of the transaction is economically similar, and any public sector specific issue is addressed separately.

In particular, we welcome the IPSASB proposal to adopt the lessee accounting model based on IFRS 16 *Leases,* which is effective for periods beggining on or after 1 January 2019, while adding public sector specific guidance and illustrative examples.

Nevertheless, we disagree with the decision to depart from IFRS 16's model for the lessor, due that we do not consider there are public sector reasons to do so. Furthermore, we consider that a dual accounting model should apply for the lessor so as to appropriately reflect their business model.

Moreover, while we consider the new guidance on concessionary leases very useful, we think it could be potentially streamlined.

[1] For the sake of clarity, the views presented in this comment letter do not represent the views of the EU Member States, or the views of the European Public Sector Accounting Standards ('EPSAS') Task Force, and are without prejudice to future decisions which may be taken in the context of the EPSAS project.

Overall we agree with the proposals included in the ED, except for the lessor accounting as mentioned in the previous paragraph. Please find in annex our detailed comments and responses to the questions included in the ED.

If you would like to discuss our comments further, please do not hesitate to contact me or my accounting team in DG Budget.

Yours sincerely,

Rosa ALDEA BUSQUETS

cc: Derek Dunphy, Martin Koehler, Bruno Gomes, Magdalena Zogala (DG.BUDG.C2), Alexandre Makaronidis (ESTAT.C.TF.EPSAS)

Appendix – Response to the questions raised in the ED

Question (Specific Matter for Comment 1) – Lessee Accounting: Right-of-use model (based on IFRS 16 *Leases*)

The IPSASB decided to adopt the IFRS 16 right-of-use model for lessee accounting (see paragraphs BC6 – BC8 for IPSASB´s reasons). Do you agree with the IPSASB´s decision? If not, please explain the reasons.

If you do agree, please provide any additional reasons not already discussed in the basis for conclusions.

Response

As a principle, we consider IPSAS standards should be as close as possible to IFRS standards, provided that there is no public sector specific reason to do otherwise. In this regard we fully support IPSASB's decision to adopt the right-of-use model for the lessee based in IFRS 16.

This model is, in our view, a better representation of the economics of the transaction. In particular, we agree that under a lease agreement, the lessee obtains the right to use an underlying asset for a period of time, and during that period the lessee has the ability to determine how to use the underlying asset and how it generates future economic benefits from the right of use.

Furthermore, we understand that a lease agreement transaction is economically similar in both the private and public sector, thus, we agree with IPSASB to take advantage of the mature stage of the private sector discussion.

Likewise, we agree to provide additional guidance for leases below market rates (Concessionary Leases), as the guidance is useful and consistent with the guidance for concessionary loans.

Question (Specific Matter for Comment 2) – Lessor Accounting: IPSASB departure from IFRS 16 *risk and rewards model*

The IPSASB decided to depart from the IFRS 16 risk and rewards model for lessor accounting in this Exposure Draft (see paragraphs BC9 – BC13 for IPSASB's reasons). Do you agree with the IPSASB's decision? If not, please explain the reasons.

If you do agree, please provide any additional reasons not already discussed in the basis for conclusions.

Response

We do not support the decision to depart from the IFRS 16 model for the lessor. We do not reach the same conclusions as to the public sector reason for this departure and we are therefore not in favour of creating an accounting gap between the private and a public sector as leasing operations are similar in both sectors.

Economics of a lease transaction is the same as in the private sector

In our view, as concluded by IPSASB in paragraph ED64.BC2, the economics of a lease transaction is the same in both public and private sector. Accordingly we understand they should not have different accounting treatments.

Furthermore, IPSASB acknowledged that the reasons that led to a departure from the IFRS model are not unique to the public sector (ED 64.BC11), however IPSASB imply that the issues may be more prevalent in the public sector, due to the fact that public sector entities usually create centralised agencies for the management of their properties. In our view, the way an entity (private or public) organises and/or manages their property should not affect the accounting treatment applied.

Asymmetry between lessee and lessor accounting

We understand the leases project in the IASB was triggered by the following criticisms, which demonstrated that the previous model failed to meet the needs of users of financial statements, in particular on the lessee side:

(a) Information reported by lessees about operating leases lacked transparency and did not meet the needs of users of financial statements;

(b) The existence of two different lessee accounting models meant that transactions that were economically similar could be accounted for in very different ways. These differences reduced comparability for users of financial statements and provided opportunities to structure transactions to achieve a particular accounting treatment; and

(c) Users had inadequate information about lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the underlying asset), particularly for leases of equipment and vehicles that were classified as operating leases.

The first two issues – lessee accounting – were addressed by the IASB through the establishment of a new accounting model ('single accounting model') based on the right-of-use model which they concluded it would result in a more faithful representation of the lessee's assets and liabilities, and also greater transparency.

On the lessor side, the IASB addressed the issue by enhancing the disclosure requirements for the lessors but kept the previous accounting model ('dual accounting model'). The decision was based on the fact that the majority of the constituents supported the dual accounting model; they suggested classification should be based on the transfer of risks and rewards, transfer of control, or sale of the underlying asset, in a manner similar or identical to the existing lessor lease classification guidance as it appropriately reflects the lessor's business model.

In line with that view, we do not agree with the IPSASB conclusion in paragraph BC9 (c)(ii)[2], that the *lessor should not derecognise the underlying asset in a lease transaction.* In practical terms, we understand the paragraph implies that the new IPSAS would mainly be applicable for operating leases, while part of the finance leasing (using the old terminology) would be accounted for as acquisitions according to other IPSAS. In particular, in the cases mentioned in paragraph 63 of IFRS 16, we understand the lessor, according to the ED, only has 2 options: (i) the transaction is a sale and it derecognises the underlying asset and recognises a Loan/trade receivable (out of scope of the lease standard); or (ii) the transaction meets a definition of a lease and the underlying asset is not derecognised.

In our view, under a finance lease it might happen that the lessor provides the rights and rewards to the lessee, but retains rights associated with ownership of the underlying asset despite having provided the control of the right of use, and

[2] ED 64.BC9 (c)(ii): "*As a finance lease would derecognize the underlying asset. The IPSASB is of the view that a lease conveys the right to use an underlying asset for a period of time and does not transfer control of the underlying asset to an entity—transactions that do transfer control are sales or purchases within the scope of other Standards (for example, IPSAS 9, Revenue from Exchange Transactions or IPSAS 17, Property, Plant, and Equipment). Therefore, the IPSASB considered that the lessor should not derecognize the underlying asset in a lease transaction*"

therefore the lessor should not account for the transaction as a sale (in accordance with other standards) but also not keep the underlying asset in its balance sheet.

Due to the fact that we consider the dual accounting model more appropriate for the lessors accounting and ED 64 narrows the scope (only including operating leases), we support the asymmetry between the two models. In summary, we see no valid reasons to depart from IFRS 16's model.

In addition, we think that a dual accounting model should apply for the lessor accounting, i.e. a lease should be first classified as finance or operating, with the underlying asset derecognised only for a finance lease.

Considering the above, we suggest that IPSASB review the conclusion, or preferably explain the reasons for departure from IFRS 16's model.

Lack of guidance for the Lessor accounting in the ED

As explained, we understand that the IPSASB proposed model may in fact scope-out finance leases. In any case, a lessor must at the inception of each contract assess, based on all facts and circumstances, whether it provides the lessee with the use for a period of time, or in substance sells the underlying asset to the lessee. This exercise involves judgement of the future lessee's behaviour in line with the terms of the contract.

For that reason, IPSASB should consider providing additional guidance for situations where the initial judgement of the lessee's behaviour does not correspond to the actual behaviour. For example, if the lessee is likely to exercise an acquisition option, but in the end decides not to, it is unclear for us how the lessor should then account for the underlying asset.

Additional guidance in this regard would avoid diversity in practice.

Consolidation issues

As mentioned before we do not consider that the consolidation issues would be more prevalent in the public sector than in the private sector. In fact, we do not consider them to be issues but challenges arising from the complexity of the transaction that obliges the transaction between entities within the same consolidation scope to be completely eliminated so as to present a single economic entity (IPSAS 35.14).

According to IPSAS 35.40(c) an entity shall eliminate in full intra-economic entity assets, liabilities, net assets/equity, revenue, expenses and cash flows relating to transactions between entities of the economic entity (surpluses or deficits resulting from intra-economic entity transactions that are recognized in assets, such as inventory and fixed assets, are eliminated in full).

Paragraph BC10 identifies the consolidation issues considered by IPSASB:

(i) *Consolidation issue 1: Where the lessor and the lessee are part of the same economic entity, and the lessor classifies a finance lease, the underlying asset is not recognised by either party.*

Applying IFRS 16's guidance at the individual financial statements level, neither the lessor nor the lessee recognise an asset in their financial statements, as they would recognise a lease receivable and a right to use the underlying asset, respectively.

However, in the consolidated financial statements the underlying asset is recognised based on its nature, since the entire lease transaction is eliminated in full, this entire (intercompany) transaction is eliminated and the asset is reclassified to the category where was booked before it was leased to the other entity of the group.

We agree that it adds complexity but we do not believe this is an issue or a reason to depart from the IFRS model.

In our view, the current requirement to keep the underlying asset in the lessor's books in all cases, aiming to avoid *the underlying asset is not recognised anywhere*, will undermine the relevance and reliability of the individual over the consolidated financial statements.

(ii) Consolidation issue 2: *separate records will need to be maintained to report the underlying asset.*

We agree that separate records of the underlying assets will have to be kept, however this is a consequence of having intercompany transactions. Consolidation adjustments are needed for other similar types of transaction, such as an acquisition of an asset by an entity of the same group, in particular if it includes a margin, separate records are already needed for consolidated financial statements.

Therefore, although we agree it increases complexity we do not see it as a reason for concluding that the IFRS model is not appropriate for the public sector.

(iii) The use of different accounting models may make leasing transactions less understandable to same users of the financial statements. It may also be difficult for users to distinguish between a lease and the sale of an asset in a lessor's financial statements.

Our understanding is that these arguments are actually valid for the IPSASB's proposed model, as users will not be able to understand the substance of the transaction. Even if the lessee will consume the asset during its entire useful life it is still shown in the lessor's balance sheet.

Risk and rewards incidental model ownership

We would also like to comment on the risk and rewards incidental model which, we do not consider to be inconsistent with the notion of control included in the conceptual framework for the recognition of an asset.

We note that paragraphs CF.5.11-5.12 state that an entity must have control of the resource, demonstrated by the ability of the entity to use the resource (or direct other parties on its use) so as to derive the benefit of the service potential or economic benefits embodied in the resource in the achievement of its service delivery or other objectives.

In assessing whether it presently controls a resource, an entity assesses whether the following indicators of control exist: (i) Legal ownership; (ii) Access to the resource, or the ability to deny or restrict access to the resource; (iii) The means to ensure that the resource is used to achieve its objectives; and (iv) The existence of an enforceable right to service potential or the ability to generate economic benefits arising from a resource.

As a consequence of this guidance, in particular the second and third criteria, we disagree with IPSASB that the risk and rewards model is inconsistent with the notion of control.

Stated-owned enterprises

We note that the consolidation scope of a public sector entity might include also entities operating in the private sector, for which the proposed guidance (keeping the underlying assets) would be even more inappropriate, since they could not compare their financial statements with the other players of the market.

Question (Specific Matter for Comment 3) – Lessor Accounting: Proposal for a single right-of-use model

The IPSASB's decided to propose a single right-of-use model for lessor accounting consistent with lessee accounting (see paragraphs BC34 – BC 40 for IPSASB's reasons).

Do you agree with the requirements for lessor accounting proposed in this Exposure Draft? If not, what changes would you make to those requirements?

Response

As previously mentioned in our reply to SMC 2, we disagree with the proposed departure from IFRS 16's model since we do not agree there is a public sector specific reason and the private and public sector transactions have the same economics and features, therefore they should have the same accounting treatment.

Moreover, we consider that it would be more appropriate and beneficial for the understandability of the financial statements to have a dual accounting model for the lessor.

In this sense, on top of the current model proposed by IPSASB, we suggest to create an additional step, similar to the IFRS proposal, classifying the lease as finance or operating, based on whether it transfers substantially all the risks and rewards of the underlying asset. Examples and indicators of whether a lease would classify as finance or operating should be provided on a principle basis.

However, unlike the IFRS 16's model, we support IPSASB on the view that for the operating lease a lessor should recognise the underlying asset and the lease receivable, as this presentation provides more complete information for the users of the financial statements.

We understand that this is a dual accounting model for lessor, in contrast to a single model for the lessee; however we believe that it would better depict the business model of a lessor, in line with the user's views.

Finally, we noted that in paragraph 82 of the ED 64 it is assumed that there are cases where the lease agreement transfers the ownership of the underlying assets to the lessee, which should depreciate the right-of-use on the basis of the useful life.

Despite the fact that we agree with the text of the paragraph we consider it is inconsistent with the accounting model for the lessor as it envisages that the lessor should never derecognise the underlying asset.

Question (Specific Matter for Comment 4) – Additional guidance for Concessionary Leases

For lessors, the IPSASB proposes to measure concessionary leases at fair value and recognise the subsidy granted to lessees as a day one expense and revenue over the lease term consistent with concessionary loans (see paragraphs BC 77 – BC96 for IPSASB´s reasons). *For lessees, the IPSASB proposes to measure concessionary leases at fair value and recognise revenue in accordance with IPSAS 23 (see paragraphs BC112 – BC 114 for IPSASB's reasons).* *Do you agree with the requirements to account for concessionary leases for lessors and lessees proposed in this Exposure Draft? If not, what changes would you make to those requirements?*

Response

We support IPSASB proposal to add additional guidance on concessionary leases.

Concessionary lease – for lessor

The ED includes guidance on concessionary leases in paragraphs 15, 22 and AG60.

Overall we agree with the guidance provided and we think it is useful, however, we believe that if a transaction meets the definition of a lease, the ED should apply, even if the lease is for no consideration instead of referring to different frameworks such as national standards.

As it might lead to diversity in practice we suggest to treat all the non-exchange component included in the lease in the same way, this is by using paragraph 23 and AG61(b) of the ED also for leases for no consideration or nominal amount.

Concessionary lease – for lessee

In line with our previous comment, we consider that the flowchart in paragraph 62 should not include the last step that relates to leases for no consideration or nominal amounts. The same accounting treatment should apply for all non-exchange part of the lease, regardless of the amount.

Distinguish among financing transactions, grant or combined (paragraph AG60)

We would like to suggest to IPSASB to reconsider whether distinguishing among financing transactions, grants or both is needed in this regard. As we previously mentioned, we consider that if a lease agreement meets the definition of a *lease,* and it contains a non-exchange part, the treatment should be the same, regardless of whether is just below the market value or for zero. We agree that the assessment if the lease is below market rate is necessary, however further assessment of whether the consideration is 'nominal' will be very judgemental and may to lead to unnecessary divergence in practice.

Leases for no consideration

The ED defines in paragraph 5 a lease as "*a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time* ***in exchange for consideration***" and *Concessionary leases* as "*a lease at below market terms*".

Accordingly, a lease agreement for no consideration does not fit with the definitions and therefore it seems that leases at no consideration – that are likely to occur in the public sector – are out of scope (despite paragraph 22 includes a flowchart that foresees leases for zero or nominal amount).

For consistency purposes, we suggest to change the definition of a concessionary lease and/or lease in order to encompass leases for no consideration.

Additional comments for IPSASBs consideration:

Recognition exemption for lessor

The guidance for lessees includes two recognition exemptions: short-term and low value; however for the lessors only one exemption is provided: short-term.

According to the explanation, IPSASB decided not to provide the recognition exemption for the lessor as this relief is already given by IPSAS 1 based on materiality threshold.

Although we agree with IPSASB reasoning that such guidance is already available, on the other hand, we consider it might raise doubts amongst preparers about what was the intention of the Board to explicitly provide the exemption for lessees and not for lessors.

Consequently, for the avoidance of doubt and to give clarity on the application of the standard, we strongly suggest explicitly providing the exemption for the lessor in the body of the standard (or otherwise exclude the exemption for the lessees from the standard as well).